

Local Protectionism

The Bottleneck of China's Economic Development

Research
China

More and more foreign companies have been entering China since the country became a formal member of the WTO in December 2001. Local protectionism, however, exists in many places and on different levels. Sabotaging both the efforts to establish and consolidate market order and the fight against fake and shoddy products, local protectionism is becoming the main cause for the weakening international competitiveness of Chinese enterprises.

By HOU Yu

Regional protectionism has long been blamed for economic inefficiencies and investment disincentives in China. Although the term generally refers to the differential way in which local governments treat local and non-local products and enterprises, the practice differs from place to place. In some cases, local governments allow small, polluting firms to churn out resource-depleting, copycat, or low quality goods. In other instances, local governments issue laws and regulations that discriminate against non-local products and enterprises. This generally results in the proliferation of low-technology factories, especially those producing household appliances such as TVs, refrigerators, and recorders. As the provinces all have similar industrial structures, their protected industries do not complement each other. The result, rather, is wasted resources, competition between regions and, on a global level, uncompetitiveness.

Local governments everywhere have incentives to protect local industries. They rely on these industries for tax revenue and also care about maintaining local employment, which is important for social stability and, in democratic states, for electoral success. Local governments thus often find it prudent to erect trade barriers to protect local industries from inter-regional competition. The problem is similar to protectionism in international trade; it should, however, be easier to ensure smooth inter-regional trade as national governments retain authority over their local counterparts. In the United States, for example, the constitution prohibits interstate tariffs. This has greatly facilitated the inter-regional trade of goods and services and has led to regional specialization in industrial production.

Policy discrepancies

In the period of China's economic transition, an unfortunate combination of economic policies on central and local level is the primary cause of local protectionism. Prior to 1978, China had a highly centralized fiscal system. All tax revenue first went to the central government. Its planning commission had the authority to determine the expenditures of local governments and allocated revenue from the central pool accordingly. This system removed tax revenue and expenditure from the hands of local government, and provided few incentives for local protection or local production.

Since the 1980s, China has implemented numerous fiscal reforms. The 'tax contract' system (*shuizheng baogan zhi*) and 'tax assignment' system (*fenshui zhi*) gave local governments more autonomy in fiscal matters. At the same time, greater local autonomy in the provision of scientific and technological infrastructure has enabled local gov-

ernments to invest in their own projects, determine the allocation of resources and engage in foreign trade. The increase in the number of rural township enterprises has strengthened the power of local governments. Before 1979 the central government's tax revenue accounted for 70 per cent of the total, with the remaining 30 per cent going to local governments. Since the reforms, this ratio has reversed.

In the early 1980s, the policy of 'let some people and some regions prosper before others' created another kind of regional protectionism. Due to its implementation, a growing wealth gap has sprung up between the regions. China's southeastern coastal areas, such as Shanghai, Jiangsu, Zhejiang, Shandong, and Guangdong, have become fairly well off due to rapid economic growth while the provinces of China's midwest, such as Henan, Gansu, Ningxia, Qinghai, and Guizhou, remain poor.

The benefits of maintaining local employment are obvious and universal; as mentioned earlier, local governments are concerned with employment in their respective regions of governance. It is widely acknowledged that there exists an enormous amount of surplus labour within Chinese state-owned enterprises of all types. To ensure social stability, both local and central governments are compelled to maintain employment of these workers. Most state-owned enterprises are administered by local governments and remain important political constituents for local government officials.

Local governments thus do their utmost to develop local economies, in order to increase their financial revenue and benefit local people. The result is regional protectionism that prioritizes local-benefit-oriented economic development. The regions compete with each other in pursuing their interests, thereby consolidating the larger struc-

ture in which the interests of local bureaucracies and local businessmen coincide.

Local protectionism and WTO rules

'In a country without a united market', stated an executive working for a foreign-invested automobile company in Shanghai, 'the biggest headache is to sell our products from one city to another'. The company's cars sell well in the south, but are barred from entry in some northern markets. Envious of the company's substantial investments in the south, and fearing the threat its entry would pose to local automobile makers, officials refused to grant license plates to cars the company tries to sell in the north.

As regional protectionism results in more tax revenue being retained at the local level, the central government has experienced shortfalls. Furthermore, regional protectionism has led to the fragmentation of larger markets and the atomisation of local markets, which goes against the WTO rules.

In order to lure foreign investment,

China has offered preferential measures for regions and types of investors; concessions have been offered in enterprise income tax and import tariffs. The principle of international treatment, however, dictates that FIEs (Foreign Investment Enterprises) should neither be discriminated against nor treated favourably. To honour its commitments to the WTO, China must adopt unified policies for the whole nation and must not favour one region or enterprise over another.

Regional protectionism – by protecting the backward, inflating trade costs, blocking the equitable allocation of resources, and hindering the formation of large-scale economies – is becoming the main cause for the weakening international competitiveness of Chinese enterprises. The Chinese government is increasingly aware of these problems, as two final examples show.

At the 2002 China Mayor Forum, the mayor of Fuzhou announced a bold policy to help foreign companies sell their goods in the city, regardless of where they locate their headquarters. Chongqing, the largest industrial city in the West, decided early in 2002 to abolish its time-honoured policy of levying additional fees on the sales of cars made in other provinces. Although this decision will result in Chongqing losing tens of millions of yuan, it would, according

to Chongqing's vice mayor, force local automakers to learn how to compete. 'It is a live-or-die question. The mission is not easy, but we have no choice.'¹

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- 1 People's Daily online, <http://english.peopledaily.com.cn> 26 March 2002.

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